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KKR partner sees competition for contracted renewables, without high returns

By Lucas Bifera

Brandon Freiman is a partner with KKR & Co. LP's North American Infrastructure team, where he helps manage the firm's investments in power and midstream assets. The firm recently posted its second-quarter earnings, which highlighted gains from energy-sector investments, and also spelled out the firm's commitment to growing its renewable holdings as a part of its environmental and social governance policy. In this interview, Freiman discusses some of KKR's views on investments in contracted renewable assets and how competitive power markets may offer some upside on conventional merchant assets.

The following is an edited transcript of that conversation.

KKR North American Infrastructure partner Brandon Freiman

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S&P Global Market Intelligence: What is KKR's role in infrastructure investments?

Brandon Freiman: The two biggest pillars of our infrastructure effort are power and oil and gas midstream. Our first fund, raised in 2010, was about $1 billion, and our second fund, raised last year, is a bit over $3 billion. If you look at where those funds have been invested, in our first fund, power was the largest area of focus, and we did only a little midstream. Our second fund, which is about a third of the way committed, has been inverted toward midstream, and that is a reflection of where the markets are and where we are seeing opportunities.

What are the macro factors driving your strategy?

In the second fund, we have done a fair bit of power in Europe in particular. One on a company called Acciona, and another X-ELIO, both of which have a global renewables focus. In North America, we saw a lot of opportunity to do utility-scale solar in our first fund. But since then, given where interest rates have trended and how capital markets have looked at renewables, that space has gotten quite competitive.

We found utility-scale solar projects have gone for rates of return, in many cases, in the mid-single digits, which is just not as interesting to us. We have spent more time recently in North America, looking at residential solar, and that's an area where there's been more of a disruption and dislocation, which has given us an opportunity to find stuff to do.

But we have found that in an environment where interest rates are pretty much 0%, a lot of these projects are getting returns that are just not attractive relative to other sectors, and so that is why you've seen us do a couple midstream deals in this second fund, in Canada and Mexico.

What could drive higher returns on the power side, relative to midstream?

You need to take some development risks, as opposed to just buying built projects that are already de-risked, and that's something we have done in Europe. In North America, you are just not seeing as much new development on the utility-scale renewables side today, with more happening on the residential side, particularly in states with robust incentives, and so that's where a lot of the capital has focused. We've found that sector has become so financially engineered, where these projects are being developed in mid-single digit returns. So much capital that flew into the sector in the 2014-2015 time period, and so the sector is going through a little bit of a shake out at the moment.

Over the next few years you will see things stabilize with a few scaled developers on the residential side, and that is when there will be more opportunity and more sustainable market for residential solar. People are getting creative in other ways to invest in power, and you are seeing much more discussions around storage as a back-up capacity. If you can replicate peaking capacity with storage, that could also be quite interesting.

What factor does policy play in your residential solar outlook?

The approach in the U.S. has been very episodic, every few years we get visibility around what those incentives will be. So it does make it difficult to boot up a platform that is going to develop projects when there is not a great feel for the runway. These technologies in many cases do need that support to get off the ground, whether it is tax incentives or feed-in-tariffs in Europe, and that is only magnified by the fact that conventional power prices are so low right now, with natural gas prices near $2-$3/MMBtu. When prices were around $4-$6/MMBtu a number of years ago, that created a lot more room for renewables to be competitive.

So what you have seen people like us really do, is focus on asset-level investments, which for the most part, have been insulated from any changes in regulations.

What about contracted projects makes them attractive?

We need to find some angle, some view on additional development or contracts or re-contracting opportunity, but we can't just be bidding on a fully de-risked stream of cash flows. In a world where interest rates are 1% in North America, you're not going to be able to invest in those kinds of projects at levered returns in the low-double digits, which is what we tell our investors we are going to seek over the long term, and in many cases, they go for mid-single digit returns, which is not completely out of line relative to where the world is.

Beyond renewables, how might merchant assets fit into your investment thesis?

The merchant space is severely cyclical, and that works both ways. If you enter at a depressed time, and the market moves in your favor, you certainly need to have the ability to exit. Given severity of those cycles, you need to have the capital structure and patient capital to ride out downturns, and we have that in our funds. In our first fund, there are investments we made in 2010 that we still hold, and there are others we've exited at very attractive returns. In this second fund, we are willing to take merchant risk around the edges, but the core of our focus is on contracted projects.

Do you account for power market design in your investment approach?

Absolutely, in the sense that if we look at contracted project for 10 years, you still need to have a view on the price thereafter, and the residual value of the project. The market structures across the U.S. are so different from each other, ranging from Texas with fully merchant market without capacity prices, to the Northeast, which is a merchant market with capacity markets that vary fairly widely. In PJM, for example, the capacity market gives you a one-year payment you lock in advance, whereas others have at least a few years of capacity prices. Then you have other, more hybrid markets, where you are contracting with incumbent utility, and there is much game theory that comes into how you can re-contract when you have sort of one buyer.

Clearly having a robust capacity payment system, that gives long term visibility, will drive the most stable levels of investment.

Article amended at 10:46 a.m. ET on Aug. 5, 2016, to note that KKR's European assets include Acciona and X-ELIO.